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Fairtrade versus Rainforest Alliance

One goal – Two strategies

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Abstract

This study is a comparative analysis of Fairtrade and Rainforest Alliance focusing on the effects generated by a minimum price respectively investment support. The framework for this analysis is based on a study of litterateur addressing income support as a way of generating a more stable situation for the farmers as well as an increased income. An important aspect of income support is how it can affect the farmer's production decision hence work as a coupling support. The question at issue for this paper is Fairtrade's respectively Rainforest Alliance' capability of generating insurance, wealth and coupling effects. The results from this comparison show how Fairtrade respectively Rainforest Alliance are both capable of generating a wealth effect, and that their potential varies as the world market price changes from a low level to higher level. Although constrained by the uncertainty of how much of the Fairtrade Certified production that will actually be sold under Fairtrade conditions, the minimum price will to some degree generate an insurance effect hence stimulate production. This incentive is not built into the Rainforest Alliance' investment support to the same degree. Furthermore, a coupling effect is more likely to be generated by the minimum price compared to the investment support.

Abbreviations

CAP	Common Agricultural Policy
CIMS	Centro de Intelligencia sobre Mercados Sostenibles
EFTA	European Fair Trade Association
EU	European Union
FAO	Food and Agricultural Organization
FLO	Fairtrade Labeling Organization
FLO-CERT	Fairtrade Labeling Organization Certification
FSC	Forest Stewardship Certification
GDP	Gross Domestic Product
LDC	Least Developed Country
IFOAM	International Federation of Agricultural Movements
NEWS	Network of European World Shops
NGO	Nongovernmental organization
SAN	Sustainable Agricultural Network
UNCTAD	United Nations Conference on Trade and Development
WFTO	World Fair Trade Organization

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1 Introduction

In this Chapter an introduction will be presented as well as the purpose of this thesis. The question at issue is presented followed by method and delimitation.

To systematically generate a higher income for poor farmers in developing countries would be an efficient way of reducing poverty, as close to 70 % of the world's poor are depending on agriculture for their livelihoods.¹ However, the potential of agriculture being a driving engine for development is constrained. One way of helping the farmers to embody this potential is to provide support, a strategy used by both Fairtrade and Rainforest Alliance which through certification provide consumers with an opportunity of contributing to poverty reduction. However, their strategies for improving the economic situation for their certified farmers are different.

Fairtrade, being a provider of price support and promoter of cooperatives with a strong focus on small scale farmers is unique for its focus but also for its guaranteed minimum price.

Rainforest Alliance works more on a business to business level by promoting sustainable agricultural practices as being crucial for long term productivity within agriculture. Through investment support such as knowledge about the values of agro- forestry farming as well as education in how to implement more efficient and sustainable production practices, producers are given an opportunity of generating higher returns. Being Rainforest Alliance Certified is a way of accessing a segment of the market where buyers are willing to pay a higher price for production certified under social and environmental standards. Different strategies, different effects and different outcomes are generated as these two organizations believe in two different concepts for achieving the same goal.

¹ FAO (2009)

1.1 Purpose

Fairtrade and Rainforest Alliance are using two different methods in order to achieve higher returns for farmers in developing countries. I believe it is interesting to compare the potential of these two interventions as an insight to their differences and similarities can work as a future base for improving these two strategies. My aim with this paper is to provide a comparative analysis of the effects generated at the farm gate level by the minimum price provided by Fairtrade and the investment support provided by Rainforest Alliance. I will in this comparison focus on the insurance effect, the wealth effect and the coupling effect as they are the foundations of the large body of literature addressing the effects of income support.²

My questions at issue for this paper are therefore:

Do Fairtrade respectively Rainforest Alliance generate insurance, wealth and coupling effects at the farm gate level? Through what channels are these effects generated?

1.2 Methodology

In order to perform a comparative analysis of the different strategies of Fairtrade respectively Rainforest Alliance I start by performing an economic analysis of Fairtrade's minimum price focusing on whether insurance, wealth and coupling effects are generated. The effects of the investment support provided by Rainforest Alliance are then analyzed as a counter analysis to the results from the economic analysis of Fairtrade.

The economic analysis of Fairtrade is based on a qualitative study of literature addressing the theoretical aspects of price support as well as the specific effects of the minimum price provided by Fairtrade observed in various case studies. The

² see Antón (2005), Hennessy (1998), Horowitz and Lichtenberg (1996), and Rude (2008)

lack of systematic empirical data limits a general application of theory to the observed empirics.

The counter analysis of Rainforest Alliance is based on a qualitative study of literature addressing the theoretical aspects of investment support with a strong focus on human capital. As there is even less objective data accessible showing the effects of Rainforest Alliance' investment support the counter analysis is to a large extent based on theory, with the exception of a study performed by CIMS showing the performance of four different certification programs in the coffee sector within Latin America, with Rainforest Alliance and Fairtrade being two of them.³ Information is also collected from SwedWatch (2008)⁴

1.3 Delimitation

A variety of variables must be analyzed in order to perform a complete comparison of Fairtrade and Rainforest Alliance. I have in this thesis only focused on the effects of Fairtrade's minimum price respectively Rainforest Alliance' function as a provider of investment support at a farm gate level when performing my comparative analysis. I've chosen to do this because of the extensive literature available addressing the effects of price support as I believe it provides the analysis with a clear framework firmly and securely established in theory. In this paper I will therefore not look at the differences in standards, the effects of Fairtrade's Social Premium and promotion of cooperatives or how the two organizations are viewed by consumers. The value of a label such as Fairtrade and Rainforest Alliance is determined by its credibility and reputation. Credibility and reputation is determined by standards, testing, certification and enforcement.⁵ This paper is therefore not an attempt to analyze the value of Fairtrade respectively Rainforest Alliance. It is therefore the minimum price respectively investment support that I refer to when discussing Fairtrade and Rainforest Alliance if nothing else is pointed out.

³ CIMS (2003) cited in Kilian et al (2004)

⁴ SwedWatch (2008)

⁵ Golan et al (2001) p.135

1.4 Outline of the thesis

In chapter 2 a short and very general overview of the situation for poor farmers in developing countries is given by presenting some of the prevailing opportunities, needs and constraints. Chapter 3 explains the theoretical framework of this paper. In Chapter 4, History as well as the strategy of Fairtrade respectively Rainforest Alliance are presented. Chapter 5 contains an economic analysis of Fairtrade. In Chapter 6 a comparative analysis is presented with the results from Chapter 6 as the base for a counter analysis of Rainforest Alliance. In chapter 7 the main conclusions are presented and Chapter 8 contains a list of the references used in this paper.

2 Development – A road full of obstacles

2.1 Agriculture – Risky business with great potential

Agriculture is risky business as it is depending on the quality and quantity of natural resources for its productivity with climate shocks such as seasonal flooding, droughts, crop disease and unpredictable soil quality being just some of the many sources of risk. Furthermore, uncertainty is also generated from the fluctuating world market prices for agricultural products and during the last few years' high prices for agriculture inputs has been one of the reasons for increasing food prices.⁶

In 2008, World Bank estimates show that three out of four people living in developing countries lives in rural areas with most of them depending directly or indirectly on agriculture for their livelihoods.⁷ This is one of the reasons for why agriculture is seen as a sector with great potential of being an important engine for development and particularly poverty reduction as various cross country studies indicate that GDP growth generated in the agricultural sector is twice as efficient compared to growth in any other sector in regards to reducing poverty.⁸

From mainly exporting traditional agricultural products, an increasing share of developing countries' export in agriculture products comes from fresh produce such as fruit and vegetables as well as processed foods and quality products such as gourmet coffee.⁹ Farmers' access to these markets involves an opportunity of

⁶ FAO (2010)

⁷ World Bank (2008) p. 26-27

⁸ Ibid p. 29

⁹ Johansson (2009) p. 61-62

higher returns as the world market price for these products are in general higher relative to more traditional agricultural products.

World Bank (2008) points out how increased productivity through better techniques, better infrastructure, improved market access, diversification opportunities, investment in capital (human and social) and well functioning natural resource management strategies are all key aspects in the process of allowing the people working in the agriculture sector to use it's built in potential.

¹⁰

2.2 Diversification – Lower risk and higher income

Despite the potential of agriculture, risk remains as a constant threat to agricultural production. One way for the farmers to deal with this risk is to diversify. By producing different crops the farmers can subdue the negative effects of economic shocks such as reduced demand but also increase returns by changing production to more profitable crops such as cash crops or high quality crops.

The potential of diversification being a risk reducing strategy does not only lie within the agricultural sector, but extends into other sectors. The potential of tourism being a prosperous source of income for many of the poor living in rural areas has over the year's got increased attention from both governments, NGO's and international organizations. Services and particularly tourism is recognized by the United Nations Conference on Trade and Development (UNCTAD) as one of the best opportunity and most vigorous sector in order to generate socially and environmentally sustainable development in the least developed countries (LDC's). In 24 LDC's tourism is not only the leading export of services but also an important source of foreign currency exchange. If this sector is properly incorporated in development strategies it has a potential of being one of the main

¹⁰ World Bank (2008) p.56-58

engines in the process of eradicating poverty and incorporating the LDC's in the global economy.¹¹

To have the possibility to diversify within but also outside of the agricultural sector is therefore an important precondition for the farmers' capability of adapting to changes on the market.

2.3 Sustainable production – A matter of survival

In developing countries, about 1, 2 billion people rely on agro forestry-farming systems that help sustain agricultural productivity and generate income. 80 % of the people living in developing countries are also dependent on the forest for their primary health and nutrition needs as it is a provider of fruits, herbs and protein. The forest is the only source of medicine for about 75 % to 90 % of the population of the developing world and small scale forest product enterprises are among the three top ten off-farm income sources.¹² Statistics presented by Food and Agriculture Organization of the United Nation (FAO) showing that the global net annual loss of forest between 2000 and 2010 was 5,2 million hectares, an area equivalent to Costa Rica are therefore alarming.¹³

Poverty forces many farmers to extract unsustainable livelihoods on the expense of forests, soils and fisheries and environmental policy is not enough to change this behavior as it is often a matter of survival.¹⁴ Deforestation leads to the loss of diversification opportunities and degradation is a threat to the potential of the tourism sector in LDC's. Unsustainable production practices is not only a threat to long term national productivity it is also a global problem as deforestation leads to substantial losses of carbon oxide storage hence eliminate one of the tools for combating global warming.¹⁵

It is in this context important to point out that small scale farmers are not the main contributors to degradation and pollution as they only control small shares of

¹¹ UNCTD (2001)

¹² FAO (2007)

¹³ FRA (2010)

¹⁴ Ekins (2000) p. 53

¹⁵ Todaro and Smith (2006) p. 471

the world's natural resources and it is therefore not enough to reduce poverty in order to prevent the negative effects of degradation. At the same time it is the poor farmers that will suffer to most from degradation. They are the ones most dependent on property resources and they often don't have enough assets to adapt to the effects of degradation.

2.4 Bad functioning markets constrains the farmers' potential

There are a variety of constraints stopping the prosperity of agriculture and poor farmers' lack of credit is often mentioned as one of the main problems. High risk and no collateral is not a great starting point when looking for a loan to finance a new machine, a better irrigation system, a change to more sustainable production methods, education for your children or starting capital for a new business.

In a study by Tijani et al (2010) profitability and constraints for 80 randomly chosen tomato producers in Nigeria are investigated. The study show that the main constraints for scaling up production in order to increase profitability is lack of credit, expensive inputs and price fluctuations with credit being by far the main problem.¹⁶

Another aspect often discussed when it comes to development is the importance of property rights. Well functioning property rights would work as an efficiency enhancing institution in a market with various market failures. For example, well functioning property rights could stimulate a more sustainable production as it would create incentives to care for the land used in production. It would also allow for environmental policy to be developed and most of all implemented and enforced.

Finally there is the problem of fluctuating prices on the commodity market. It leads to misallocation of resources as governments tries to dampen some of the negative effects and the farmer' tries to adapt to the rapidly prevailing changes.

¹⁶ Tijani et al (2010) p. 129, 132

This makes risk-averse farmers avoid markets that could be profitable in the long run.¹⁷

¹⁷ Adebuseyi (2004) p. 3-4

3 Theoretical framework

3.1 Effects of price support / price floor

Price support in agriculture can be used for purposes such as insuring self sufficiency in food, stabilizing and sometimes increase income for farmers, stimulate rural development and maintain biodiversity among others. The development of the European Common Agricultural Policy (CAP) illustrates how price support, if incorrectly designed stimulates production. The dynamics of political economy where strong interest groups makes it difficult for any politician wanting to minimize this support is not the only reason why it's difficult to avoid this distortion. The process of decoupling support is complicated and has been going on for many years within the EU. Rude (2008) looks at the reforms of CAP such as the "set aside land" the concept of the "multifunctionality of agriculture" and the "Single Farm Payment" and concludes that these reforms have lead to a more decupled support. However, he also points out that dynamic implications such as the effects on exit and entry decisions, expectation effects and wealth effects remain.¹⁸

In order to understand the effects of income support it is necessary to look closer at the reasons for why farmers respond to income support programs in a certain way. Antón (2005) does this by illuminating the importance of structural features and constraints as well as the economic incentives created by the income support program in order to understand how farmers will react and why. He concludes the outcome of the support program, will depend on the prevailing

¹⁸ Rude (2008) p. 462-463, 468

structure of the sector where the program is implemented as well as the design of the program.¹⁹

3.1.1 Structural features set's the frames

Farmers are facing several constraints and bottlenecks when striving towards maximizing profit. Each situation is more or less unique but the crucial factors that decisively affect how farmers respond to an income support program has been summarized by Antón (2005) in the following four categories:

- Production factors

What technology is available and how easy is it for farmers to adjust to current as well as new technology? Is farming labour or capital intensive? To what extent can labour be replaced by capital?

- Relative availability of resources or inputs.

This is affected by price and mobility but also by legal and physical constraints.

- Competition on the input market

If any of the input markets such as the market for land, capital or risk is imperfect or incomplete the farmer's preferences when it comes to risk or work versus leisure will affect his production decision

- Expectations matter

How farmers respond to income support also depends on expectations. Whether the farmer trusts the initiator of the program or not matters for how he/she respond? These expectations can be affected by how the program is implemented, if it is expected to be a long or a short term intervention, and also to what extent there is access to information.²⁰

¹⁹ Antón (2005) p. 3

²⁰ Antón (2005) p. 6

These features are necessary to map out in order to understand farmers response to income support. The way these different features are combined is also often correlated with farm specific characteristics, the degree of economic development and the existence of markets and legal frameworks such as property rights. Other important determinants are infrastructure, geography, climate and agronomic conditions.²¹

3.1.2 Design determines incentives

In order to understand, predict or in the case of reforming CAP change the outcome of a price support program, it is important to identify the reason for why certain incentives are created. Antón (2005) does this by classifying the four following implementation criteria's; a) the nature of the variable that determines the amount of the payment received; b) the mathematical relationship between variable a) and the amount of payment received; c) the limits of conditions imposed that constrain the direct application of a) and b) and d); the commodities and activities that are covered by variable a).²²

If one agricultural product is eligible for support and another agricultural product isn't, this can affect how resources such as capital and labour are allocated. An incentive to allocate resources to the product eligible for support is created. If an income support program is based on outputs or market price support it can create incentives for the farmers to maximize profit by using all the production inputs.²³

3.1.3 Receiver of price support – Wealthy, Insured and Coupled

An often used component when analyzing the structure and dynamics of the agricultural sector is the farmer's preference for risk as it is believed to have a

²¹ Antón (2005) p. 6

²² Ibid p. 3

²³ Ibid p. 4-5

large impact on production decisions.²⁴ It is therefore important to take consideration to risk when analyzing the effects of price support.

A theoretical framework often used when analyzing how price support policies affect production decisions within the agricultural sector was developed by Hennesy (1998). This framework decomposes the effects of price support in to an insurance effect, a wealth effect and a coupling effect.

According to Hennesy (1998) an insurance effect can only be generated if the price support is based on the source of uncertainty.²⁵ Price support can stabilize an otherwise fluctuating stream of income. Fluctuating prices implies a risk and with price support this risk can be reduced. As a risk averse producer such support is beneficial as it generates an insurance effect through a more stable and predictable income. If the degree of risk faced by the farmer is reduced, this will have a positive effect on production.²⁶

Price support will also affect the total wealth of the farmer, the so called wealth effect. Wealth-enhancing price support will generate additional incentives to produce. This conclusion is based on the assumption that individuals willingness to take a risk increases when their wealth increases.²⁷

Finally there is a coupling effect, which alters the optimal production decision towards taking full advantage of the income support. This affect appears if the price support is designed in a way where the farmer through production decisions can affect the size of the support.²⁸

Price support can, based on the above theories affect production, income and incentives to diversify.

²⁴ Horowitz and Lichtenberg (1996) p. 926

²⁵ Hennesy (1998) cited in Rude (2008) p. 459

²⁶ Hennesy (1998) p. 46

²⁷ Ibid p. 46

²⁸ Ibid p. 50-51

3.2 Investments are crucial for development

Another way of providing support is by using an investment support policy. A useful way of analyzing how farmers will respond to investment support is to look at it as a subsidy of capital (physical, human, natural etc). There are two useful ways of extending such analysis. The first is to analyze investment support as a lump sum subsidy. The second is to look at to what degree the investment support is linked to a certain production technique or input requirement. The two different approaches will be discussed in more detail below.

3.2.1 A lump sum subsidy – Efficient but difficult to implement

Rude (2008) writes “A lump sum transfer is one where the recipient cannot affect the size of the transfer by changing his behavior in any manner” as the definition points out the agent’s incentives will not be altered when implementing such transfer hence a lump sum transfer can be implemented without distorting how resources are allocated within the economy.²⁹

With a lump sum subsidy the farmers production frontier will shift outward hence generate a higher income.³⁰ Furthermore, if we assume that investment support is provided as a lump sum subsidy production decisions will not be altered. Nor will it generate an insurance effect as it is not based on the source of uncertainty but on fixed criteria.³¹ However, it is difficult to design an investment support policy in a way that the producers decision is to no degree affected and although lump sum subsidies would be an efficient way of providing support they are not likely to generate such efficient outcome when implemented in reality³²

²⁹ Rude (2008) p. 459

³⁰ Varian (1999) p. 27-28

³¹ Rude (2008) p. 459

³² Hindricks and Myles (2006) see discussion about lump sum taxes p. 373 -380

3.2.2 Investment support with conditions

If investment support is given in a way that regulates how production is to be performed or what inputs to use a coupling effect will be generated and as a lump sum subsidy is difficult to implement in reality this is likely to happen.

An insurance effect is only generated if the investment support is linked to the source of uncertainty.³³ This means that the type of conditions linked to investment support will determine whether an insurance effect is created or not.

A wealth effect on the other hand depends on how a subsidized investment in capital affects the marginal product of the farmer. One way of modeling this is done by Golsbee (2001) who extends the work of McLure (1974) who used a two sector model to show how wages are affected by investments in capital. McLure (1974) shows that an investment subsidy of the output in one sector will generate a higher return for this output relative to the other sectors output. This higher price will lead to increased wages in the subsidized sector. However, the starting point for this argument is a short run perspective. In a long run perspective one can assume that a reduction in capital cost caused by an investment subsidy will reduce the relative price of capital to labour in both sectors and the capital intensity of the two sectors will matter for the outcome. Also, in a long run perspective labour is assumed to be fully mobile. This will lead to a situation where the wage difference between the two sectors evens out as the workers move to the sector with the highest wage.³⁴

Based on the above theory one can therefore assume that investment support will in the short run generate a relative wealth effect but this effect will in the medium run decrease and in the long run disappear.

3.2.3 Food crops versus cash crops

Food production is for many of the world's poor household important for two reasons; it secures their own food consumption and it generates an income as the products can be sold at the market. The increasing demand for biofuel is one

³³ Hennessy (1998) cited in Rude (2008) p. 456

³⁴ McLure (1974) cited in Goolsbee (2001) p. 7-8

example of how cash crops can be a more profitable alternative to food crops for poor farmers. Over the recent years concerns for how this might affect LDC's self sufficiency of food has been raised. I will not further discuss these concerns but instead illuminate how investment support targeting food crops can generate indirect effects as the food crop and cash crop sector are interlinked.

Most of the private and public investments targeting the agricultural sector are focused on cash crop as the returns are easily appropriable hence focus is on other crops than those that are important for developing-country livelihoods.³⁵ However, investment support can have indirect wealth effects if it is implemented in the food production sector. De Janvry (1991) argues that by investing in productivity enhancing techniques in the food crop sector production of food as well as consumption of food can be increased hence lead to resources being released. These resources can then be used for cash crop production which will lead to a higher diversification rate as well as increase the chance for a higher income. De Janvry (1991) concludes that increased investments in the food crop sector is a precondition for success³⁶ Or as concluded by Braun et al. (1989) in a study of how cash crop production affects food crop production in six African countries *“the promotion of technical change in the production of food crops is essential to allow smallholders to capture greater gains from market integration in cash crops”*³⁷

³⁵ Naseem et al (2010) p. 146-147

³⁶ De Janvry (1991) p. 1415-1416

³⁷ Braun et al. (1989) cited in De Janvry (1991) p. 1415

4 Two strategies – One goal

4.1 Fairtrade: Goal and mission

Fairtrade's vision is a world in which all producers can enjoy secure and sustainable livelihoods, fulfill their potential and decide on their future. Fairtrade see as their mission to link disadvantaged producers with consumers, promote fairer trading conditions and empower producers to combat poverty, strengthen their position and take more control over their lives.³⁸ According to the Fairtrade Labeling Organization (FLO) the benefits of being certified lies within four different aspects; stable prices, which is the focus of this paper, access to a Fairtrade premium, partnership and empowerment³⁹

4.2 History of Fairtrade

The roots of the fair trade concept can be traced back to the 1940's, but it wasn't until the 1960's and 1970's it became a movement.⁴⁰ In 1988, a Dutch fair trade organization called Max Havelaar launched the first fair trade certification label in order to differentiate fair traded coffee from Mexico from other types of coffee. This certification was found in Dutch supermarkets and was soon spread to Denmark, Belgium, Switzerland, Norway and France. Other fair trade certification labels followed in Max Havellar's footsteps such as Transfair (in Germany, Austria, Luxemburg, Italy, the United States, Canada and Japan), the

³⁸ FLO (2009a)

³⁹FLO (2010a)

⁴⁰ More (2004) p. 73

Fairtrade Mark in the UK and Ireland, Rättvisemärkt in Sweden, and Reilu Kauppa in Finland. Up until 1997 there was no coordination between these different certification marks and the risk of causing confusion among consumers resulting in lower sales was a concern that had to be dealt with. The Fairtrade Labeling Organization (FLO) was established in 1997 and it was a step towards harmonizing fair trade standards with the aim of uniting these different labels under one joint certification mark. FLO cooperated with World Fair Trade Organization (WFTO), Network of European World shops (NEWS) and European Fair Trade Association (EFTA) in order to harmonize standards and in 2002 this cooperation under the name FINE resulted in the launch of the international Fairtrade Certification Mark. In order to avoid the potential complications with being both the standard setter as well as the certifier and to increase credibility and trustworthiness FLO was split into two independent organizations in 2004. Since then FLO is the standard setter and provider of producer support and FLO-CERT is responsible for the inspections and certification of producer organizations as well as the audit of traders. Another big step was taken in 2007 when Fairtrade became a full member of ISEAL⁴¹, a globally recognized and independent association for social and environmental standards.⁴²

Today there are about 746 certified producer organizations in 58 countries and FLO estimates that 5 million people are directly benefitting from the Fairtrade program.⁴³ The producer organizations are organized as cooperatives with some of them consisting of between 100 and 1000 members.⁴⁴ The growth in sales of Fairtrade products has during the last 5 years showed an average annual growth rate of 40 %. In some national markets Fairtrade Certified products are representing up to a 50 % market share in certain products.⁴⁵ Despite a significant growth in Fairtrade products its total share of world trade remains small, for the most important products where coffee is the most important in regards to value and bananas in regards to volume the total share is below 1 %.

⁴¹FLO (2010b)

⁴²ISEAL (2010)

⁴³FLO (2010c)

⁴⁴FLO (2010d)

⁴⁵FLO (2010c)

Approximately 1, 5 million farmers are certified by Fairtrade. In order to understand this figure one can relate it to the approximately 25 million farmers producing coffee in Asia, Africa and Latin America, or by relating it to the approximate of 880 million poor people living in rural areas where they are directly or indirectly depending on agriculture for their income. This illustrative comparison is done by Johansson (2009)⁴⁶

What started out as a grass root movement with “world shops” being the only channel for sales has developed in to a well known label and is today a common feature of the product range in many of the big retailers.

4.3 The strategy of Fairtrade

The strategy of Fairtrade where consumers are given the opportunity to contribute to the combat of poverty by buying certified products can be divided in to the following three components; requirements for how farmers need to be organized, standards and price support.⁴⁷ These will below be discussed in more detail.

4.3.1 A cooperative creates seller power

Based on previous studies Ronchi (2005) writes “*Strategies aimed at improving the returns to coffee through quality premium earnings can address the ‘crisis’ of low incomes for producers only to the extent that price transmission is complete and incomplete price transmission is often the consequence of imperfect competition in the marketing chain*” However, skills, capital and dedicated personnel willing to take the role as middlemen in the production chain is necessary in order for farmers to successfully be integrated and organized with the aim of strengthening their position.⁴⁸

⁴⁷ Johansson (2009) p. 10

⁴⁸ Ronchi (2005) p. 11

Making the price transmission more efficient has not only been a strategy promoted as a way of reducing world poverty, its benefits has since many years been recognized in the Western World with the Swedish meat and dairy sector being an illustrative example. In a report published by the Swedish University of Agricultural Sciences it is concluded that with a bad functioning commodity market and with the existence of large transaction specific investments, uncertainty and huge potential for economies of scale, partial vertical integration is a better way of solving the coordination problems than the pure market mechanism.⁴⁹

Even if the Swedish meat and dairy industry has proven that the benefits of cooperation can outweigh the costs and that in the long run would be beneficial for poor farmers to organize it is still a difficult and long process to train individuals in how to take on the role as middle men. The forming of producer organization was therefore dismissed in 2003 by TechnoServe Business Development among others for not being an efficient policy when it came to solving the crisis of low incomes for producers. Some policy makers did however realize the gains of helping poor farmers to organize and saw how NGO's such as Fairtrade could work as providers of the information and support poor farmers need in order to develop efficient and successful cooperatives.⁵⁰

A democratically organized cooperation between small scale farmers, cooperative being one type of organization being promoted, is one of FLO's criteria in order to be eligible for Fairtrade certification. The aim of forming cooperatives and producer organizations is to improve the price transmission.

Better conditions and higher prices can subsequently be generated by farmers sharing fixed costs for marketing, credit and certain inputs. In a situation where institutions are weak and public investments are close to non-existent this local cooperation can work as an alternative solution when it comes to financing schools and dealing with environmental issues. This way of cooperating can also function as a source for micro credit, an aspect often discussed as an efficient way of improving income for poor people in rural areas.⁵¹ More recently the criterion

⁴⁹ SLU (2003) p. 216

⁵⁰ Ronchi (2005) p. 11

⁵¹ Deininger (1995), Milford (2004), Molinas (1998) summarized in Johansson (2009) p. 49

for producer eligibility has been extended and plantations with hired labour are today eligible for certification when it comes to tea and bananas. Coffee on the other hand is still a product where only small scale farmers are eligible.⁵²

4.3.2 Standards and the certification process

The Fairtrade Certification Mark certifies that a certain product fulfills the standards set by FLO concerning social, economic and environmental conditions of the production as well as the trading process. The product standards are divided into two categories. The first category deals with product standards for small-scale producers and the companies which trade with these small-scale producers. The second category of product standards applies to companies employing hired labour and the companies that trade with them.⁵³

Ronchi (2005) writes “*In many ways, the story about Fairtrade can be told in terms of coffee*”⁵⁴ and without arguing whether this is true or not it is important to point out that Fairtrade has been successful in expanding their product range. Today, even if most of the products eligible to be certified are food products with coffee, bananas and tea in the forefront the FLO is working hard to develop standards for additional products and examples of other types of products that have been made eligible over the years are flowers, cotton and footballs.⁵⁵ Fairtrade does not certify producers, only products. Fairtrade standards require that 100 % of ingredients that can be Fairtrade certified are and for multi-ingredient products all ingredients for which there are Fairtrade standards must be certified. Multi-ingredients products are therefore required to have a label that clearly highlights the individual ingredients that are certified.⁵⁶

The key objectives for setting the FLO standards are:

- ensure that producers receive prices that cover their average costs of sustainable production;

⁵² Reynolds (2000) p.303

⁵³ FLO (2010e)

⁵⁴ Ronchi (2005) p. 4

⁵⁵ Johansson (2009) p. 10

⁵⁶ FLO (2010f)

- provide an additional Fair-trade Premium which can be invested in projects that enhance social, economic and environmental development;
- enable pre-financing for producers who require it
- facilitate long-term trading partnerships and enable greater producer control over the trading process;
- set clear minimum and progressive criteria to ensure that the conditions of production and trade of all Fair-trade certified products are socially, economically fair and environmentally responsible.⁵⁷

To become certified is a process that involves different steps from application to audit with visits and inspections of the production sight, evaluation by FLO-CERT, cooperation between the farmer and FLO-CERT concerning what needs to be done in order to fulfill the FLO standards and if being eligible for the Fairtrade Certification Mark annual visits and inspections to affirm that the high standards of FLO is being followed.⁵⁸ This process can with all its documents be complicated, it can be time consuming and most of all costly. The fees vary depending on what kind of producer organization it is. In 2007 the minimum charge found for the smallest group (less than 100 producers or employees) was around 1530 pounds rising to about 2400 pound if the producer organization provides central services.⁵⁹ These are no small sums for a poor farmer in a developing country even if they split the cost among all the members of the producer organization. In 2002 Fairtrade launched its Producer support management network, which has the aim of providing technical assistance as well as market information, organizational development and training in financial management.⁶⁰

⁵⁷ FLO (2010e)

⁵⁸ FLO-CERT (2010)

⁵⁹ Booth and Whetstone (2007) p. 31

⁶⁰ Fairtrade Resource Network (2010)

4.3.3 Price support

The main goal of Fairtrade is to increase income for farmers in developing countries and the price support consists of the minimum price (minimum wage) and the social premium.⁶¹ The minimum price is constructed in the following way:

*Fairtrade minimum price = production cost + living cost + costs for complying with Fairtrade standards.*⁶²

The difference between being a certified farmer and a non-certified farmer varies depending on what the world market price is. When the world market price is lower than the Fairtrade minimum price this price floor comes in to effect and works as a stabilizer, the lower the market price is the bigger is the relative benefit of being certified.

In order to calculate the appropriate level of the minimum price research for each product is undertaken and by consulting producers as well as expert the world the price is set. Fluctuating market and input prices makes it difficult for the Fairtrade price to always cover the cost of sustainable production. In order to avoid this problem to the largest extent possible, Fairtrade prices are periodically reviewed and changed in order to adjust to prevailing changes.⁶³

When the world prices are higher than the Fairtrade minimum price, the Fairtrade price becomes the world market price plus the social premium. The Fairtrade premium is a money transfer from the consumer to the producer who receives this payment automatically if selling a Fairtrade certified product. The social premium is supposed to be a support for socioeconomic development and empowerment. The size of the premium is between 5-30 % of the minimum price and is paid per unit of Fairtrade Certified products sold. The FLO does not set rules for what projects are to be financed by the social premium but they require that the choice of projects should be decided on in a democratic way and be implemented in a way that's transparent to both the members of the organization as well as the FLO.⁶⁴ Even if there are no rules for what projects to be financed

⁶¹ Nicholls and Opal (2005) p. 53

⁶² Ibid p. 41

⁶³ FLO (2010g)

⁶⁴ FLO (2009b) p. p.4-6

by this premium it is often used for social projects such as improving local schools, health, water or sanitation projects hence it is beneficial not only the farmers involved but also the whole local community.⁶⁵

4.4 Sustainability – The core of Rainforest Alliance

According to Rainforest Alliance its certification program rests on three pillars of sustainability; environmental protection, social equity and economic viability. They build their concept on the thought that by protecting and conserving ecosystems you can also protect the people, wild animals, and plants that are depending on these systems. Rainforest Alliance strives to protect biodiversity, ensure sustainable livelihoods and generate development. The tools for achieving this are investment support for a better farm management, certification of producers and dissemination of information in order to increase demand for certified products.⁶⁶ A better environment and a sustainable use of natural resources is seen as the way forward when it comes to a improving the situation for producers and a must in order to achieve long term and sustainable development.

4.5 History of Rainforest Alliance

In 1986, as a reaction to the increased deforestation in developing countries and the growing concern for its effects on human life and activity a grass root movement later called Rainforest Alliance was founded in New York.⁶⁷ The importance of sustainable practices within farming as well as other types of production affecting the environment was and is still today the core of Rainforest Alliance.

⁶⁵FLO (2010g)

⁶⁶Rainforest Alliance (2010a)

⁶⁷Rainforest Alliance (2010b)

In 1989 the organization took its first step by founding the world's first global forestry certification program, the so called Smart Wood Program. At the same time their first office outside America was opened in Costa Rica where the two first certifications of agricultural practices were issued to two independent banana farms.⁶⁸ In 1993, Rainforest Alliance was one of the founders of Forest Stewardship Council (FSC)⁶⁹ which today is a world known and respected standard setter for responsible forestry practices.⁷⁰ The Smart Wood Program is today following the guidelines set by the FSC and Rainforest Alliance is one of the largest accredited FSC-certifier.⁷¹

Since the launch of the Smart Wood program in 1989 the coverage of the certification program has expanded and today focus is not only the forestry sector but also agriculture and tourism. Chiquita was the first big company to cooperate with Rainforest Alliance and over the years other multinational companies such as Unilever, Kraft food, Mars and Mc Donald's have followed in Chiquita's footsteps.⁷²

Since 1992, almost 35,000 farms (1, 2 million acres⁷³) ranging from small family cooperatives to large plantations have been given the Rainforest Alliance Certification seal⁷⁴ However, the cost of becoming certified is high as the standards were originally developed for large and medium size farms and this makes it difficult for small scale farmers join Rainforest Alliance. This was concluded in a study by SwedWatch in 2008 in which it was also concluded how despite efforts to attract small scale farmers this process had in 2008 not yet been successful.⁷⁵

The certification program was in 2008 covering 63 countries and 130 million acres of forest had been certified. The total sales of certified products were close to 3 billion dollars.⁷⁶ Apart from different kinds of forestry products about 22 different kinds of crops are eligible to be certified and a development towards

⁶⁸Ibid

⁶⁹ Ibid

⁷⁰ Info Pack (2009)

⁷¹ Rainforest Alliance (2010c)

⁷² Rainforest Alliance (2010d)

⁷³ 1 hectare = 2,47 acres

⁷⁴ Rainforest Alliance (2008a)

⁷⁵ SwedWatch (2008) p. 42-45

certifying services is seen as Rainforest Alliance has taken on the tourism sector in their certification strategy.⁷⁷ In 2004/2005 Kraft Foods imported 840 ton of Rainforest Alliance Certified coffee to Sweden, this amount is close to the amount of coffee imported by Fairtrade.⁷⁸ Together with the FSC, Rainforest Alliance have developed standards for oil palm and sugar cane. With the increasing demand for biofuel crops and the pressure on deforestation that this creates, it is crucial to develop and encourage sustainable agricultural practices for this category of crops.⁷⁹

4.6 The strategy of Rainforest Alliance

Rainforest Alliance does not promise a price premium and has been described as an organization that mainly works on a business to business level in order to facilitate large volumes of certified products to the consumers.⁸⁰ Or as the President of Rainforest Alliance put's it "*We're focused on using markets to affect change at scale*"⁸¹ Their strategy is to provide information and knowledge in order to help the farmers to increase productivity and reduce costs. The Rainforest Alliance Certification seal is promoted as a way of differentiating a certified product from other non-certified products and as a way of accessing a segment of the market where environmental and social consideration is rewarded by a higher price. With the possibility of receiving higher returns, economic incentives to practice a more sustainable farm management are created.⁸²

4.6.1 Standards and certification process for agriculture

The Rainforest Alliance Certification guarantees that standards set by the Sustainable Agriculture Network (SAN), an alliance of locally based NGO's

⁷⁶ Rainforest Alliance (2008a)

⁷⁷ Rainforest Alliance (2009a)

⁷⁸ SwedWatch (2005) p. 62

⁷⁹ Rainforest Alliance (2008b) p. 29

⁸⁰ Kilian et al (2004) p.33 and p. 41

⁸¹ Whelan, President of Rainforest Alliance (2009)

⁸² Rainforest Alliance (2009b)

working towards social justice and conservation are met. The standards are designed with the aim to protect wildlife, wild lands, worker's rights and communities. The members of SAN are the owners of the standards and also the one's responsible for updating these standards.⁸³

The key objective for setting the SAN standards are:

- Integrating sustainable production of crops and livestock into local and regional strategies that favor biodiversity conservation and safeguard social and environmental well being.
- Raising awareness among farmers, traders, consumers and business leaders about the interdependencies among healthy ecosystems, sustainable agriculture and social responsibility.
- Impressing upon business leaders and consumers the importance of choosing products grown on environmentally sustainable and socially responsible farms.
- Stimulating dialog among environmental, social and economic groups, North and South, about the benefits of sustainable agriculture⁸⁴

Local experts within the SAN perform inspections of each farm at least once a year as farms must continue to demonstrate progress after being certified in order to keep their certified status.⁸⁵ Apart from the costs of becoming and remaining certified plus the costs of changing production in order to live up to the SAN standards there is no specific fee for using the Rainforest Alliance Certification seal owned by Rainforest Alliance.⁸⁶

The certification process can be initiated by the producer and also by the buyer. A third way of initiating a process is sometimes taken by Rainforest Alliance it's self. Rainforest Alliance then looks at products that have a large environmental impact and maps out the structure of its market. After identifying the key players and countries an evaluation is made and the next step is to recruit

⁸³ SAN (2009) p. 4-5

⁸⁴ Ibid p. 4

⁸⁵ Rainforest Alliance (2007)

⁸⁶ Whelan, President of Rainforest Alliance (2009)

and coordinate players at different levels of the production chain in order to work out a plan for how the farm management can become more sustainable. Ideally small players take the lead and later big companies capable of taking the product in to mainstream business will follow.⁸⁷

To become certified the producer have to comply with half of the standards set up by SAN with some of the standards such as use of chemicals, child labour and wages weighing heavier than some others.⁸⁸ This could make it easier for small scale farmers to join as they initially don't have to take on all the costs of changing production practices. However, according to IMA Flora which is one of Rainforest Alliance' certification organizations in Brazil the reason for why small farmers do not join is the costs for being inspected as well as their resistance of changing their production methods.⁸⁹

Another comment to the 50 % compliance requirement is expressed by Gunnar Rundgren, previous President of International Federation of Agricultural Movements (IFOAM). He views Rainforest Alliance as an organization which believes that it's more important to reach out to a large share of the farmers instead of only a few and they accept that cooperation with large companies is the only way of doing this, which makes it a necessity to accept that everything can't be perfect when it comes to conditions out on the farms.⁹⁰

4.6.2 Investment support

Parallel with certification is a variety of programs aiming at helping the producers to live up to the SAN standards and to continue improving their farm management. This part of the strategy can be analyzed as an investment support where focus is not only to teach farmers about the value of agro forestry farming and sustainable agricultural practices but also to help them change their way of producing towards more efficient and environmentally sustainable production

⁸⁷ Ibid

⁸⁸ Swedwatch (2008) p. 42-46

⁸⁹ Ibid

⁹⁰ SwedWatch (2008) p. 44-45

techniques. Two examples of what can be achieved through this investment support is illustrated by two cases from Vietnam respectively Kenya.

In Vietnam a successful cooperation between Rainforest Alliance and some of Vietnam's leading coffee exporters resulted in a more socially and environmentally sustainable production. More efficient production techniques were introduced in order to reduce the negative effects of intensive farming. Apart from helping the farmers to develop an efficient accounting system for keeping track on the size of harvests and the use of water and pesticides, the use of pesticides was also restricted. The introduction of a well functioning waste system was another improvement generating a better situation for both the farmers working within in coffee sector but also for people living in the surrounding area.⁹¹

Another concrete example of how Rainforest Alliance promotes sustainability is their strive to plant new trees on the land of Kericho Estate, a tea plantation in Kenya. This project is driven by the owner of the plantation together with Unilever and Rainforest Alliance. Focus in this project was also a better water management in order to avoid pollution. With the aim of decreasing the current deforestation rate improvements of the factory were made in order to reduce the use of fire wood in production. The cooperation has also resulted in that Kericho Estate has been introduced to the market for renewable material.⁹²

⁹¹ Rainforest Alliance (2010e)

⁹² Rainforest Alliance (2010f)

5 Economic Analysis

5.1 Fairtrade - A provider of price support

Price support can be seen as the driving force of Fairtrade's strategy and it is also the component that makes Fairtrade different to many other fair trade organizations. Price support consisting of both the minimum price and the social premium works as an incentive to improve conditions regulated under FLO standards. This could in itself be a step in the right direction towards a better situation for the farmers/workers involved. I will in this economic analysis only focus on the minimum price and I will do this by analyzing if, and how, insurance, wealth and coupling effects can be generated.

5.2 Insurance effect

5.2.1 Only a part is Fairtrade

A minimum price does to some degree generate an insurance effect hence a risk reduction is achieved for certified farmers compared to non-certified farmers. One of the reasons for why this effect is only generated to some degree is that all production produced by certified farmers is not actually sold as Fairtrade.

Estimates by FLO show that only 20% of the total certified production is actually sold under Fairtrade conditions.⁹³

In order to live up to the standards set by Fairtrade, changes must be made by producers. These changes involve costs and the farmer's decision to start the process of being certified is in itself a decision where risk has to be taken in for consideration.

Willingness to pay a higher price for Fairtrade Certified products is likely to decrease as the price difference between certified products and non-certified products increase. In case of a supply shock the market price will adjust in order to match the current demand. With a set minimum price this flexibility is lost. With an increasing price difference between certified and non-certified products this lack of flexibility will lead to decreasing demand for certified products, resulting in less production being sold under Fairtrade conditions. There is therefore a risk that the benefit of the minimum price guaranteed by Fairtrade might in times of low world market prices be outweighed by the reduced sales of Fairtrade Certified products caused by decreasing demand.⁹⁴

At the same time as Fairtrade guarantees that the minimum price will cover production costs hence the farmers are to be compensated by the consumers for the changes they make, the fulfillment of this promise is constrained by demand. The larger share of production being sold as Fairtrade the larger is the insurance effect for the certified farmers compared to the non-certified farmers. But demand fluctuates and it is impossible for the farmer to know how much of his total production will be bought for Fairtrade's minimum price. Because of this, the risk imposed by fluctuating prices is not fully eliminated for the Fairtrade Certified farmers.

Another channel through which this uncertainty can remain is by how benefits of Fairtrade are distributed within the cooperative. This aspect is illuminated in a study made by Parrish et al (2005). In their study they look at two different market-based interventions, Fairtrade Certification and Techno Serve Business Development and the different effects generated when implemented at two different coffee producer organizations in Tanzania. The study looks at how

⁹³ FLO (2007)

these two strategies affects the farmers by using the sustainable livelihood framework where the effects on five different types of capital and two types of institutions are analyzed⁹⁵ A result from this study relevant for this section is how the financial benefits of Fairtrade were not distributed systematically within the producer organization. Premium benefits went to whichever farmer was ready to sell at the time Fairtrade contracts had to be filled. This made it impossible for the farmers to predict whether their coffee would be sold as Fairtrade Certified which made any incentive to modify behavior based on expected higher income to diminish.⁹⁶

Based on the above it becomes obvious that farmers' access to information is crucial in order for them to take a decision that reflects their risk preference. I have found no studies or information about a cooperative being certified without selling any of its production under Fairtrade conditions. Despite me being well aware of the fact that this does not mean there are no such cases out there, I will continue this analysis by assuming that the minimum price does to some degree have an insurance effect for certified farmers compared to non-certified farmers.

5.2.2 Risk reduction-One of the benefits of being a certified farmer

Stability in the production chain is not only beneficial for the suppliers but also for the consumers and has therefore been used by various commercial organizations within the primary product market.⁹⁷ One example are so called market-based risk management instruments often used in industrialized countries, where future prices can be locked in by using forward contracts, commodity bonds etc in order to hedge away commodity risk. This has been used for coffee, cocoa and sugar among other products.⁹⁸

The Fairtrade minimum price does to some extent work as a stabilizer for the certified farmers hence it generates an insurance effect. As the lack of credit

⁹⁴ Nicholls and Opal (2005) p. 41-43

⁹⁵ The types of capital investigated were: Financial, human, physical, social and natural. The two different institutions are processes and structures

⁹⁶ Parrish et al (2005) p. 182

⁹⁷ Both and Whetstone (2007) p. 30

⁹⁸ Adebusuyi (2004) p. 30

makes it extremely difficult for the farmers to change or diversify their production, this insurance effect is beneficial as it provides the farmer with a more predictable future, which enables long term thinking. A minimum price can strengthen the farmers' position in the production value chain and it can improve their chances of getting credit as the guaranteed minimum price works as a risk reducing intervention.⁹⁹ As discussed in paragraph 5.2.1 the balance between price and quantity sold determines the benefits of the minimum price.

Johansson (2009) among others criticize Fairtrade's minimum price for decoupling the certified farmers from the market making them less responsive to changes in demand and supply. In case of a price drop, certified farmers are to some degree protected from the worst negative effects. The problem with a minimum price is how it does not encourage these farmers to reduce their production to the same extent as non-certified farmers.¹⁰⁰

Johansson (2009) also illustrates the limitations of the minimum price as a sustainable poverty reducing strategy by visualizing a situation where all farmers are Fairtrade Certified. In such scenario all farmers would be delinked from the market and if the problem is an excess supply from the start this problem will be aggravated as the insurance effect stimulates production. The capacity of the minimum price is in such scenario also constrained by demand and at a given price consumers are only willing to buy a certain amount of the certified product.¹⁰¹ Again, one can look at CAP to see how this is not only an argument that holds in a hypothetical situation. CAP is a perfect example of how price support bias production and creates overproduction. This overproduction was also constrained by the demand, but solved by using export subsidies in order to dump excess supply on the world market. A solution not available for Fairtrade strategy as it is extremely costly to fund such subsidies.

⁹⁹ Johansson (2009) p. 52

¹⁰⁰ Johansson (2009) p 34

¹⁰¹ Ibid

5.3 Wealth effect

It makes sense to focus on whether Fairtrade generates a wealth effect or not when evaluating Fairtrade as a poverty reducing strategy. It is not only important because an increased income for poor farmers is the main goal of Fairtrade it is also a useful indicator to measure if you want to pursue economic research in a systematic way.

In order to evaluate whether a wealth effect is generated or not one must not only look at what price the certified farmers receive for their Fairtrade Certified goods but also on the costs of being certified.¹⁰²

Studies show that when world market prices are low the certified farmers get a higher price for the share of their production sold as Fairtrade if you compare to non-certified farmers. If you look at the average price this difference is smaller as Fairtrade certified farmers only sell a share of their production as Fairtrade. This can lead to a situation where the average price for certified farmers is actually below the Fairtrade minimum price.¹⁰³

In a study performed by Centro de Inteligencia Sobre Mercados Sostenibles (CIMS) from 2003 cited in Kilian et al (2004) the price premiums generated by four different sustainable certification programs for coffee production in Latin America were investigated. The data was collected in January 2004 from 463 producer organizations possessing at least one of the four different certification types representing an estimate of 90 % of all coffee exported under the four labels.¹⁰⁴ The price premiums are presented in Table 1.

Price Premiums for Green Coffee of Different Certifications, FOB (US cents/lb)				
Premium	Organic	Fairtrade	Rainforest Alliance	Utz Kapeh
Maximum	150	106	25	10
Average	15-25	62	15	7
Minimum	5	56	8	5

Table 1: Source: CIMS (2003)¹⁰⁵ *Price premium = World market price for conventionally grown coffee – price for sustainably certified coffee.

¹⁰² Kilian et al (2004) p. 36

¹⁰³ Bacon (2005), Calo and Wise (2005) and Nicholls and Opal (2005), cited in Johansson (2009) p. 29

¹⁰⁴ CIMS (2004) cited in Kilian et al (2004) p. 25

¹⁰⁵ Ibid p. 34

In 2004 the world market price for conventionally grown coffee was relatively low making the Fairtrade price premiums relatively high. Fairtrade's minimum price premium of 56 US cents/lb is the difference between the regular market price at the time of 80 US cents/ lb and the Fairtrade minimum price for Arabica coffee of around 140 US cents/lb.¹⁰⁶ The results from Table 1 show that Fairtrade generated the highest average and the highest minimum out of all the four certifications in the study and was second best when it came to the maximum price premium.

An important aspect of these results is how they represent an average for all countries in Latin America and that there are major differences when looking at the data for each specific country. The structural difference of the different countries affects the benefits of Fairtrade's minimum price as it is set at the same level in all these countries. In order to illustrate this Kilian et al (2004) calculates a theoretical price required for a coffee farmer with a medium sized farm¹⁰⁷ to participate in the national economy with the price estimated as price per pound. He finds that the Fairtrade minimum price is in Costa Rica only enough for the farmers to cover production costs. When looking at El Salvador this theoretical price show that despite covering production costs the country's inefficient management system makes the minimum price far from sufficient in providing medium-sized farms with a national average income.¹⁰⁸

In order to make sense on whether Fairtrade generates a wealth effect one must put price premiums in relation to the costs of being certified. Apart from the fees of becoming and remaining certified there are also costs generated for the farm management required in order to live up to the standards set by FLO. Collecting this data is a difficult task and research on this is still to be improved in order to draw any general conclusions. However, the studies performed so far shows that at times of low world market prices a positive wealth effect is generated for Fairtrade Certified farmers compared to non- certified farmers.¹⁰⁹

¹⁰⁶ Ibid p.35

¹⁰⁷ Medium size farm = 10 hectare

¹⁰⁸ Kilian et al (2004) p. 39

¹⁰⁹ Calo and Wise (2005), Nicholls and Opal (2005), Murray et al (2003) cited in Johansson (2009) p. 30

This effect is smaller when the world market price is higher hence the wealth effect generated by Fairtrade's minimum price compared to non-certified farmers decrease when the world market price increase ¹¹⁰

However, it is not uncomplicated to distinguish what component of the Fairtrade strategy that is actually the driving force behind its price premium. The forming of cooperatives has been proven to be an efficient way of increasing returns to individual farmers. An example of this is provided by Ronchi (2005). By investigating data collected from 157 coffee mills in Costa Rica over a period of 26 years between 1974/75 and 1999/2000 he finds that producers organized in Fairtrade cooperatives face lower mark-downs to their prices than domestically owned, single plant mills of both cooperative and non-cooperative structure. He also finds that Fairtrade mills generate a better return for farmers through an improved market power generated by improved efficiency of their organizations. The efficiency enhancing effect is by Ronchi (2005) called the "Fairtrade effect"¹¹¹

The importance of quality for generating higher returns is another important insight in this context. The result from the CIMS study cited in Kilian et al (2004) show that certification is not on its own responsible for the higher prices of sustainable coffee. The certification is only a tool for differentiating the certified product from other non-certified products and quality is seen as the main business prerequisite. In order to generate a higher price for certified products environmental and social improvements must be accompanied with quality enhancement.¹¹² Based on this result one can conclude that cooperatives as well as any certification program designed in a way that encourage production of high quality products are to prefer as they are important keys to generating a wealth effect.

¹¹⁰ Johansson (2009) p. 30

¹¹¹ Ronchi (2005) p. 50-52

¹¹² Ibid p. 34,42

5.4 Coupling effect

A minimum guaranteed price can in theory create incentives to produce a low quality as possible in order to maximize profits. This can be reinforced by the cooperative structure of Fairtrade where a free rider problem can be created. This is pointed out by Berndt (2007) who argues that the risk of farmers selling their lowest quality coffee bean to the Fairtrade buyers is present. Reason being that the price is guaranteed and a lower quality of some farmers' coffee beans is not noticeable when mixed with the cooperative's total Fairtrade sold production.¹¹³ However the risk of low quality production can be expected to diminish with uncertainty about how much of the Fairtrade Certified production is to be sold under Fairtrade conditions and also as illustrated in Parrish et al (2004) how the benefits of Fairtrade is distributed within the cooperative.¹¹⁴

The coupling effect has by far received the most critique in the evaluations of the efficiency of income support policies with CAP as an often used example. The same tendency is observed when reading different evaluations of Fairtrade as an efficient strategy for poverty reduction. As Johansson (2009) writes "*Structural change is hard for the ones having to adjust, especially in developing countries where safety nets are poorly developed and diversification opportunities are limited but the solution is not to avoid the change by tying support and better conditions to continuing production*"¹¹⁵

A minimum price will affect exit and entry rates. With a minimum price connected to certain crops inefficient producers that with no price support would leave the sector are capable of continuing their production. It can also create incentives for new producers to enter the market for crops eligible for certification hence production can be stimulated. In the case of coffee where the excess supply is often emphasized as one of the reasons for low world market prices this is not a desirable outcome. It can also work against incentives to diversify as some agricultural products are through this minimum price more profitable than others. If all agricultural products were eligible for certification, the agricultural sector

¹¹³ Berndt (2007) cited in Johansson (2009) p. 51-52

¹¹⁴ See Paragraph 5.3

could be preferred as a source of income at the expense of incentives to seek for income opportunities outside the agricultural sector.

5.4.1 Production is stimulated

Based on the above economic assessment of the effects of Fairtrade's minimum price it is clear that it is capable of generating an insurance effect, a wealth effect and a coupling effect. Economic theory predicts that the reduced risk generated by wealth and insurance effects as well as the existence of a coupling effect creates incentives to increase production. This is often pointed out as one of the main problems of the Fairtrade strategy.

The fact that certified farmers still have to find a buyer of their certified production is a counter-argument to this critique. And as been previously mentioned only 20 % of the producers' production is sold as Fairtrade Certified. These two arguments are addressed by Johansson (2009) who adds to the discussion by pointing out how the minimum price can be seen as cross subsidy. If the minimum price contributes to cover some of the fixed costs it does not only subsidize the coffee beans sold as Fairtrade but also the coffee beans sold outside of the Fairtrade contract. This stimulates production. A lower cost also leads to a higher profitability for all the coffee beans hence makes the certified farmers more competitive at the conventional coffee market as well. This does not benefit competitive non-certified coffee farmers.

There are studies showing that production is increased after being certified one example being a study of Bolivian coffee farmers where the result show that hectares planted with coffee is positively correlated with the farmer being Fairtrade Certified.¹¹⁶

As previous mentioned most of the studies evaluating Fairtrade is focused on the coffee sector. This is for obvious reasons as the coffee sector is the most mature of all the agricultural sectors eligible for Fairtrade Certification. With excess supply of coffee being one of the most significant variables explaining low world market prices the above critique is justified. But with the lack of systematic

¹¹⁵ Johansson (2009) p. 37

empirical studies on other products eligible for certification and with Fairtrade's product range expansion I believe one must not draw a general conclusion for all eligible products. One must instead acknowledge the importance of the structural features of the sector/market where the Fairtrade strategy is implemented in order to get a better idea of how farmers will respond to reduced risk generated by Fairtrade Certification. Firstly, a reduced risk might not only create production enhancing incentives but also incentives to diversify. Secondly, just because the incentive to produce more is created does not mean that the farmer is capable of doing so and excess supply is not the main problem for all agricultural products. Constraints such as scarcity of land and labour (especially when harvesting), market failures and the lack of off-farm job opportunities is likely to affect whether these incentives are transformed in to action or not which might limit the predicted coupling effect. How farmers react to reduced risk is therefore an important aspect when discussing the link between a price support policy and production. However interesting it is far too complex to be evaluated within the frames of this thesis

Today, Fairtrade certified products still represents a very small share of total world trade hence the above discussed price distorting effects are at this stage not an alarming problem. However the minimum price promoted by Fairtrade does certainly have production enhancing incentives built into its design and if the rapid growth rate of Fairtrade export continues these problems will have to be dealt with.

¹¹⁶ Imhof and Lee (2008) cited in Johansson (2009) p.41

6 Comparative analysis

Certification is a way of differentiating your product, a strategy used by both Fairtrade and Rainforest Alliance. By conditioning their support to environmentally and socially acceptable production practices economic incentives to live up to set standards are created. However, the design of a support program affects how farmers will respond. In order to illustrate the different incentives created by a price support respectively an investment support I will below compare the two strategies focusing on their capability of generating an insurance effect, a wealth effect and a coupling effect. The economic assessment of Rainforest Alliance is done as a counter analysis of the effects presented in Chapter 5.

6.1 Rainforest Alliance - Invest for sustainability

Rainforest Alliance Certification does not promise a minimum price to any of their certified producers as a matter of fact nothing is guaranteed. Instead, their strategy is to help farmers to cut costs, change to a more environmentally and socially sustainable production and create economic incentives to practice a better farm management which is crucial for long run profitability of agriculture. By using the Rainforest Alliance Certification seal the producers are given a chance to market their product in large scale to a segment of the market where buyers are willing to pay a higher price in order to get a product they consider as a high quality product. The potential of this “chance” is at all times completely determined by current demand.

6.1.1 Insurance effect

By considering fluctuating world market prices being the main source of uncertainty for poor farmers growing agricultural products the minimum price provided by Fairtrade generates an insurance effect.

The investment support provided by Rainforest Alliance will not generate an insurance effect as it is not based on the source of uncertainty.¹¹⁷ However in the case of a strong price drop on the conventional market the relative willingness to pay a higher price for a product certified as sustainable is likely to increase.¹¹⁸ Fairtrade minimum price has been proven to be successful when it comes to dampening the negative effects at farm gate level of such price drop. Although weaker, a dampening effect can also be generated by the investment support provided by Rainforest Alliance as an increasing willingness to pay for sustainably certified products makes it more profitable to be certified compared to not being certified. This relative advantage is however constrained with quantity sold for this higher price.

Before continuing this analysis sustainable production must be defined. There are different views on what's sustainable and what isn't as well as what effects "sustainable practices" generates. A correct and untied definition of sustainable production is therefore not available. If we ignore this aspect and assume that there is a "sustainable" way of producing as well as that sustainably certified production is "sustainable" an interesting aspect when it comes to Rainforest Alliance' capability of generating an insurance effect can be illustrated in the hypothetically analysis below.

In a long run perspective unsustainable production practices will lead to lower productivity.¹¹⁹ Lower productivity will lead to a decrease in supply and if we assume that demand is fixed, prices will increase. Hypothetically, this could mean that farmers using sustainable production methods have an advantage through their higher productivity relative to the one's using unsustainable practices. If we in the long run assume that environmental degradation such as

¹¹⁷ See Hennessy's definition of Insurance effect in Paragraph 3.1.3

¹¹⁸ Johansson (2009) p.30

¹¹⁹ Todaro and Smith (2006) p.471

less fertile soils or lack of agro forestry systems will be the main source of risk the support provided by Rainforest Alliance does to some degree generate an insurance effect for the future. However, farmers do not have to be Rainforest Alliance Certified to be using sustainable practices hence the same long term hypothetical insurance effect compared to conventionally grown production can be created by Fairtrade if their standards are set in a way that encourage sustainable farming. Also, degradation is not always farm specific with global warming being a good example of how degradation affects everyone no matter if you are producing sustainably or not. It is also unlikely that the certified farmers become less risk averse as this hypothetical future insurance effect is not guaranteed.

The investment support provided by Rainforest Alliance is according the theoretical definition not capable of creating an insurance effect hence incentives to produce more are not generated. However, production might still increase as investment support can make it possible for farmers to scale up production¹²⁰. The opportunity of scaling up production through more efficient production techniques is however still linked to prevailing demand, hence less distorting than the incentives created by an insurance effect

Although constrained by demand the minimum price provided by Fairtrade does generate an insurance effect hence creates incentives for enhanced production. Based on Hennessy's (1998) definition of an insurance effect, the incentives created by Fairtrade's minimum price is likely to be more production enhancing than the hypothetical incentives created by the investment support provided by Rainforest Alliance.

6.1.2 Wealth effect

In order to evaluate the potential wealth effect of the investment support provided by Rainforest Alliance I take the starting point of analyzing it as an investment subsidy of capital with a strong focus on human capital such as

¹²⁰ Tijani et al (2010) p. 132

knowledge about the values of more sustainable techniques and education in how to use these techniques. Whether investment support generates a wealth effect or not would according to the model presented by McLure (1974) depend on how the farmers' marginal product is affected by a subsidized investment. In McLure's two sectors model an investment subsidy to capital in one sector will generate a relatively higher return for the product produced by this sector. In the case of Rainforest Alliance we can assume that certification generates the higher price as socially and environmentally sustainable production increases the value of output per unit of labour. According to the model this price increase will trickle down and transform in to higher returns to the worker/farmer producing this product.

Based on this model, Rainforest Alliance' larger scale approach attracting medium and large size farmers will in the end benefit the workers on these farms as the higher price trickles down and generates higher wages. However, the McLure model is based on a variety of assumptions that can be questioned when applying this theory to reality with perfect competition being one of them.

Table 1 in Paragraph 5.3 illustrates the results from the CIMS study showing the price premiums generated by Rainforest Alliance. The minimum price premium of 8 US cents/lb generated by Rainforest Alliance is not only far below the minimum price premium generated by Fairtrade, it is also the lowest out of all four certifications. However the situation is different when looking at the average price premium with Rainforest Alliance still being below Fairtrade but somehow on a similar level as Certified Organic.

In order to say anything about Rainforest Alliance' capability of generating a wealth effect one needs to look at certification costs and productivity gains. According to Rainforest Alliance their farm management program do deliver quick dividends to their certified coffee farmers through more efficient farming, cost savings and production gains of as much as 20 %, whilst improving the quality of coffee.¹²¹ However, this is their own estimates and the lack of objective data makes it difficult to either strengthen or question this figure further.

Apart from the certification fees costs are generated in order to meet the SAN standards. Due to lack of data Kilian et al (2004) makes an attempt of estimating

¹²¹ Rainforest Alliance (2007)

these costs by drawing an interesting parallel between Rainforest Alliance and Certified Organic. By assuming that farm management costs are the same for producers within both these certification programs he shows how Rainforest Alliance will generate a wealth effect for its certified farmers as the net margin is positive after accounting for the related price premiums and costs of being certified.

Restrictions on chemical products used in production are likely to be correlated with a higher labour input per item ¹²² It is therefore an overestimation to assume that farm management costs for these two certifications are equal as Certified Organic invoke a much more strict regulation on production practices with one example being their zero-tolerance when it comes to chemical fertilizer whilst Rainforest Alliance allow the use of some chemical fertilizers. ¹²³ Kilian et al (2004) also show that even if the estimated costs would be doubled a wealth effect would be generated. This increases the probability of a wealth effect being generated by Rainforest Alliance. ¹²⁴

Another important aspect in this context is how at a state of decreasing demand Rainforest Alliance is by not interfering with prices capable of maintaining incentives to stay flexible among their certified producers. The benefit of the minimum price guaranteed by Fairtrade might in times of decreasing demand be outweighed by the reduced quantity sold under Fairtrade conditions ¹²⁵ This problem is less likely to prevail at the same extent with Rainforest Alliance as this certification strategy does not involve any kind of guarantees, which creates incentives for the certified farmers to react to prevailing signals on the market to a larger extent than farmers guaranteed a minimum price.

The large scale approach of Rainforest Alliance¹²⁶ cooperating with giants such as Kraft food and Unilever is another channel through which the negative effect of decreasing demand can be dampened.

¹²² Kilian et al (2004) p. 38

¹²³ Kilian et al (2004) p. 38, 40-41

¹²⁴ Ibid

¹²⁵ Nicholls and Opal (2005) p. 41-43

¹²⁶ Kilian et al (2004) p.42

Furthermore, this large scale approach could generate a wealth effect for small scale farmers as large scale farmers takes on the mission dampen the negative effects of degradation.

6.1.3 Coupling effect

Investment support provided by Rainforest Alliance is conditioned. In order to become certified the farmer must comply with the SAN standards and this can only be done for a limited variety of products.

This set up is also used by Fairtrade using FLO standards in order to condition their minimum price. As discussed in Chapter 5 the strategy of Fairtrade is not only productivity enhancing it also affects farmers' decision to diversify as well as their decision to exit or enter a sector. With the help of the investment support provided by Rainforest Alliance the farmer can by becoming certified increase his chances of receiving higher returns for his products relative to before becoming certified. However, there are no guarantees that this will actually be the outcome hence the farmer remain responsive to changes on the world market and incentives to alter their optimal production decision is not created to the same extent as the incentives created by a minimum price.

This way of reasoning is based on the assumption that farmers have perfect information about what the two different programs has to offer as this is what the farmers base their decision on when choosing between becoming certified or not. Limited access to objective information as well as the long distance between producer and consumer makes the farmers dependent on information provided by Fairtrade respectively Rainforest Alliance. Correct information is therefore crucial in order to combat the coupling effect. Of course there's also the risk of farmers being certified without actually living up to the set up standard due to lack of resources for inspection. As this problem as well as the importance of correct information lies outside the framework for this paper I will not go further into this discussion but instead assume that farmers do have the correct information and that certified farmers do comply with the set up standards.

Based on the assumptions above there is no distortive channel through which the farmer can take advantage of an investment support. Incentives for the farmer to alter the optimal production decision towards taking full advantage of a support

program is not built in to the design of investment support hence the coupling effect observed for Fairtrade Certified farmers will not be generated for the Rainforest Alliance Certified farmers.

Through different channels the potential of both Fairtrade and Rainforest Alliance is constrained by demand. An increasing supply of Fairtrade Certified respectively Rainforest Alliance Certified product generated through a coupling effect or not does involve future problems if this increase is not followed by demand. Certified Organic is an example of how excess supply of Organic Certified products has in various countries lead to a situation where the certified farmers are no longer capable of financing their status as certified, making them look for other alternatives and even abandon certification.¹²⁷

¹²⁷ Kilian et al (2004) p. 42

7 Conclusion

If we assume that the main source of risk is fluctuating prices for agricultural products the minimum price provided by Fairtrade do generate an *insurance effect*, creating production enhancing incentives. This effect is to some degree constrained as on average only 20 % of total production produced by Fairtrade Certified farmers is actually sold under Fairtrade conditions. Another source of uncertainty constraining this insurance effect is that the benefits of a minimum guaranteed price might be distributed unsystematically among the farmers in a cooperative. However due to the lack of data the latter mentioned source of uncertainty can not be questioned nor strengthen. Rainforest Alliance do not guarantee anything but the chance of getting a higher return, it's investment support does therefore not generate an insurance effect as it is not based on the source of uncertainty.

The two strategies are both capable of generating a *wealth effect* which is supported in empirics. However, their potential varies depending on the current world market prices and due to an imperfect market. In regards to the latter, Fairtrade might be better suited for generating higher returns for small scale farmers, whilst Rainforest Alliance is a better alternative for medium size and large scale farmers. Furthermore, with the negative effects caused by degradation and deforestation the large scale focus of Rainforest Alliance does fill a wealth enhancing function even for the small scale farmers as the benefits of a sustainable farm management at the large farms is necessary in order to dampen the negative effects of degradation. Reducing poverty among small scale farmers is not enough to achieve the same effect.

It is showed how Fairtrade's minimum price does at a state of low market prices generate a wealth effect for certified farmers compared to non-certified farmers. However smaller, the same tendency is observed for Rainforest Alliance Certified farmers. At a higher world market price this wealth effect diminishes for the Fairtrade Certified farmers as they sell less of their certified production as Fairtrade Certified. By not interfering with prices, Rainforest Alliance' keep a certain flexibility at such price change hence the costs of having a smaller share of certified production sold observed within the Fairtrade program can in theory be reduced as the design of Rainforest Alliance' investment support has no production enhancing incentives built in to its design. However, this is determined by the elasticity of demand and there are no systematic data available to either strengthen or question this later scenario.

It is also found that high quality is more important than certification when it comes to generating a wealth effect. With Rainforest Alliance giving no guarantees there are no built in incentives for the certified farmers to produce a lower quality than what's optimal. The design of Fairtrade's guaranteed minimum price could generate incentives for the producers to produce a lower quality product. However this outcome is to some degree prevented as the share of total production sold under Fairtrade conditions is uncertain.

Both Fairtrade and Rainforest Alliance generate economic incentives for the farmers to comply with the standards set out by FLO respectively SAN in order to become certified. However, based on perfect information and no risk of farmers manipulating the system there is no distortive way through which the investment support provided by Rainforest Alliance alters the optimal production decision, hence no *coupling effect* is built into its design. Fairtrade's guaranteed minimum price do generate production enhancing incentives and can also alter the farmer's optimal decision as it affects the decision to diversify as well as the decision to exit or enter. This coupling effect is however limited by the share of production sold under Fairtrade conditions as well as the uncertainty of how the benefits of the minimum price are distributed.

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